



# ASSET ALLOCATION REPORT

## *December 2021 Quarter*



- / Chartered Accountants
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*A history of shaping financial success*

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# QUARTER IN REVIEW

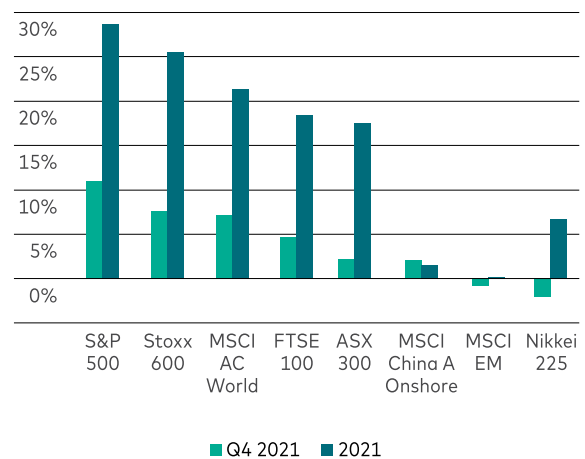
Global equity markets advanced through the fourth quarter as resilient corporate earnings and economic data continued to be challenged by prospects of higher interest rates and a new COVID variant of concern.

Markets rallied through October, fuelled by an upbeat earnings season, but momentum slowed in November as Europe faced a resurgence in COVID cases and renewed lockdowns. The emergence of the Omicron variant and the associated health and policy uncertainty saw a pre-emptive pull-back in equities, erasing gains for the month. Ultimately, optimism over the extent of the variant's impacts prevailed as central banks pushed ahead with their roadmaps for winding back stimulus, citing limited economic fallout to date.

Stocks pared losses and pushed to new record highs in the final days of 2021, led higher by the U.S. and European indexes, which retained their year-to-date leads (**Figure 3**). Emerging markets continued to be weighed down by concerns over inflation, the withdrawal of U.S. stimulus, and underperformance of off-shore Chinese equities, ending the year flat. Australian investors saw global equities advance 6.1% for the quarter and a total of 26.3% for the calendar year (**Figure 4**).

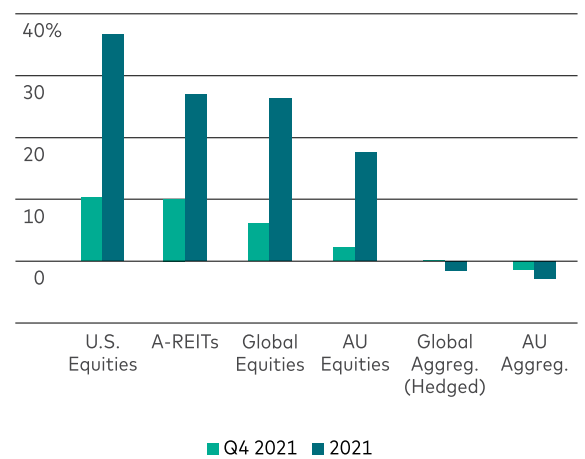
Bond markets see-sawed as reduced stimulus and ongoing inflation concerns were punctuated by surprises from the Bank of England and an Omicron-induced sell-off. Global fixed income returns finished the year flat as focus returned to inflation while long-term government yields broadly moved sideways, despite upward momentum through the end of the quarter. Meanwhile, Australian bond prices fell as markets challenged the Reserve Bank of Australia's (RBA's) yieldcurve control, prompting the bank to end the program despite maintaining a dovish policy stance relative to both market pricing and central banks abroad.

**Figure 3.** Global equities led higher by U.S. and Europe



**Notes:** Returns are cumulative total returns in local currency.  
**Source:** FactSet.

**Figure 4.** AUD returns broadly advanced



**Notes:** Returns are cumulative total returns denominated in AUD.  
**Source:** FactSet, Refinitiv



# ECONOMIC OUTLOOK

## THE GLOBAL ECONOMY IN 2022: Striking a better balance

Vanguard’s outlook for 2021 focused on the impact of COVID-19 health outcomes on economic and financial conditions. Vanguard’s view was that economic growth would prove unusually strong, with the prospects for an “inflation scare” as growth picked up. As we come to the end of 2021, parts of the economy and markets are out of balance. Labour demand exceeds supply, financial conditions are exceptionally loose even when compared with improved fundamentals, and policy accommodation remains extraordinary.

Although health outcomes will remain important in 2022 given the emergence of the Omicron variant, the outlook for macroeconomic policy will be more crucial as support and stimulus packages enacted to combat the pandemic-driven downturn are gradually removed into 2022. The removal of policy support poses a new challenge for policymakers and a new risk to financial markets.

The global economic recovery is likely to continue in 2022, although Vanguard expect the lowhanging fruit of rebounding activity to give way to slower growth in most parts of the world, whether supply-chain challenges ease or not. In both the United States and the euro area, Vanguard expect growth to slow down to 4%.

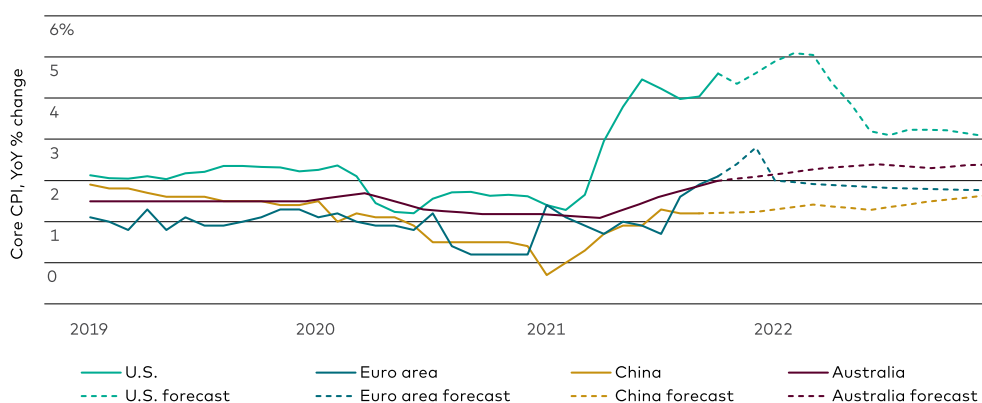
In the U.K., Vanguard expect growth of about 5.5%, and in China they expect growth to fall to about 5%. By contrast, in Australia, Vanguard expect a stronger growth rebound in 2022 of around 4.3% following lackluster growth in 2021. Although positive vaccination progress paves the way for a more resilient economic reopening, rising Omicron cases are likely to drive consumer reluctance and be a drag on near-term growth, both locally and abroad.

### GLOBAL INFLATION: Lower but stickier

Inflation has continued to trend higher across most economies, driven by a combination of higher demand as pandemic restrictions were lifted and lower supply from global labour and input shortages. While Vanguard don’t envision a return to 1970s-style inflation, they anticipate that supply/demand frictions will persist well into 2022 and keep inflation elevated across developed and emerging markets. That said, it is highly likely that inflation at the end of 2022 will be lower than at the beginning of the year given the unusual run-up in goods prices.

Although inflation should cool in 2022, its composition may be stickier. More persistent wage- and shelter-based inflation will be the critical determinant in central banks’ adjustment of policy.

**Figure 5.** How long will high inflation last?

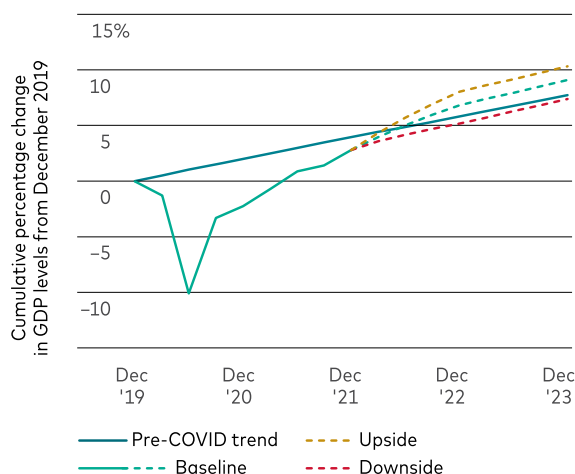


**Notes:** Data and Vanguard forecasts are for year-on-year percentage changes in the core Consumer Price Index, which excludes volatile food and energy prices. Actual inflation is through September 2021 for the U.S., U.K., and China and through October 2021 for the euro area. Vanguard forecasts are presented thereafter.

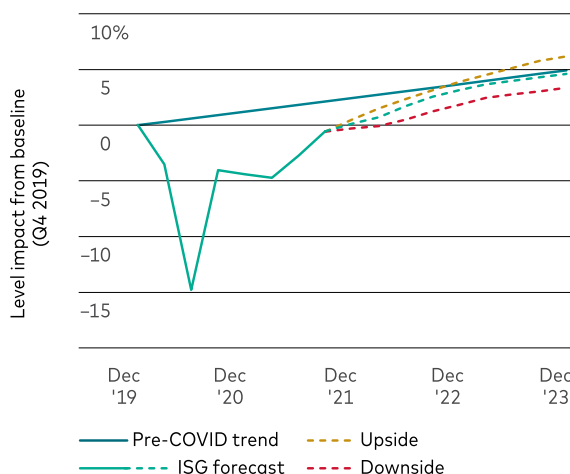
**Sources:** Vanguard calculations, using data from Bloomberg and Refinitiv.

**Figure 6.** Divergent global economic momentum

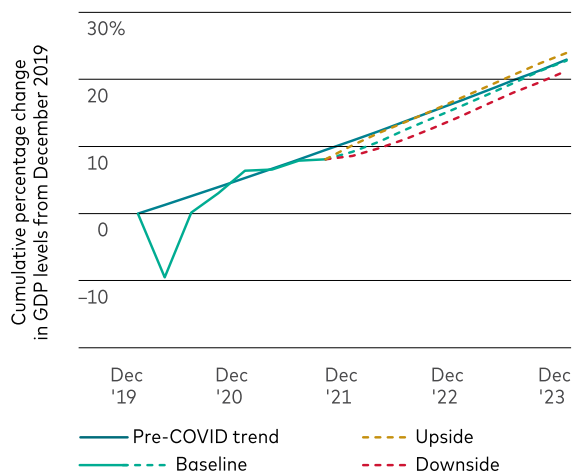
**United States**



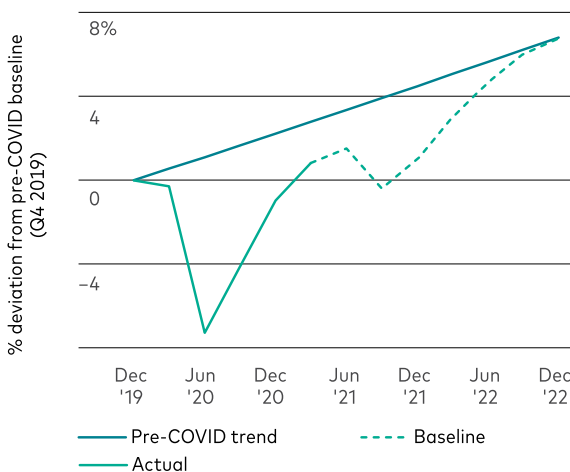
**Eurozone**



**China**



**Australia**



**Notes:** The y-axis represents the level impact from the baseline, which is December 2019. The pre-COVID-19 trend assumes an annual growth rate of 1.9% for the U.S., 1.1% for Eurozone, 5.3% for China, and 2.2% for Australia.

**U.S.:** The baseline assumes gradual normalisation in supply-side constraints with unemployment rates reaching close to 3.5% by year-end 2022. The downside scenario is characterised by a lengthier persistence of current supply-side constraints, which would continue to act as a significant drag on growth. Inflation would stay elevated as we view supply constraints dominating the demand impact on inflation currently. The upside scenario is characterised by a speedy normalisation of supply-side constraints, which will allow demand to be more fully realised and allow earlier easing of inflation pressures.

**Eurozone:** Downside risks include new virus mutations that are resistant to the latest vaccines and a renewed COVID-19 wave in winter that raises consumers' reluctance to engage in social activities. Higher-than-anticipated energy prices and taxes that squeeze household disposable incomes pose further downside risks, as do larger or more persistent global supply-chain disruptions. Upside risks include a faster-than-expected drawdown in household savings that would fuel greater consumption spending. A more rapid unwinding of industrial bottlenecks is also possible, and that would benefit the Euro area disproportionately, as manufacturing makes up almost 17% of its GDP, in contrast to just 11% for the U.S.

**China:** In the baseline scenario, we assume that current regulatory tightening continues, albeit at a more prudent pace, while macro easing in the form of fiscal and monetary stimulus picks up speed more notably starting in the second quarter of 2022 after the National People's Congress. The downside scenario is characterised by a policy mistake in the form of overly aggressive regulatory tightening and inadequate macro easing. A potential COVID resurgence leading to additional containment measures under the "zero COVID" strategy also poses a downside risk. The upside scenario would entail an acceleration of macro easing and a pause in regulatory tightening alongside surging global demand for Chinese exports.

**Sources:** Vanguard, using data from Refinitiv, Bloomberg, and Eurostat, as of November 2021.



## POLICY TAKES CENTER STAGE: The risk of a misstep increases

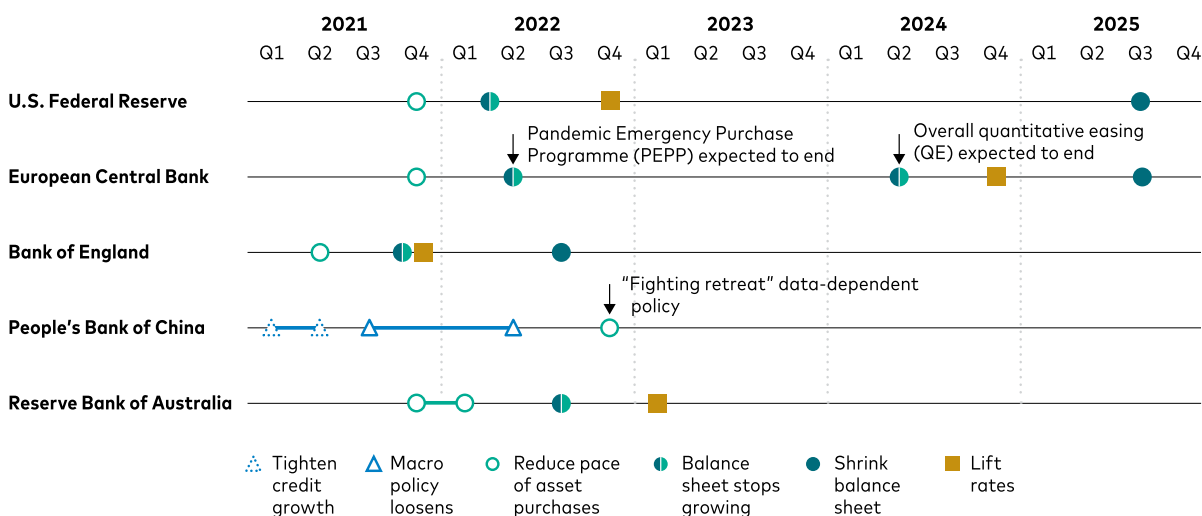
The global policy response to COVID-19 was impressive and effective. Moving into 2022, how will policymakers navigate an exit from exceptionally accommodative policy?

The bounds of appropriate policy expanded during the pandemic, but it's possible that not all these policies will be unwound as conditions normalise. On the fiscal side, government officials need to trade off between higher spending—due to pandemic-driven policies—and more balanced budgets to ensure debt sustainability.

On the monetary side, central bankers will have to strike a balance between keeping a lid on inflation expectations, given negative supply-side shocks, and supporting a return to pre-COVID employment levels. In the United States, that balance should involve the Federal Reserve raising interest rates in the first half of 2022. The pace and number of interest rate hikes over the course of this year will depend crucially on incoming wage and inflation expectations data.

At present, Vanguard see the negative risks of too easy policy accommodation outweighing the risks of raising short-term rates. Given conditions in the labour and financial markets, the Fed may ultimately need to raise rates to at least 2.5% this cycle, higher than some are expecting. In Australia, better growth prospects and rising inflation expectations are likely to see the RBA taper off its quantitative easing program by the first half of 2022. Vanguard's baseline does not see an RBA rate hike until 2023 but the risks are now tilted to an earlier liftoff. Risks stem primarily from strong labour market progress, especially among prime-age workers, and broadening inflationary pressures.

**Figure 7.** The long and winding road to normalcy



**Notes:** Vanguard assessments are as of November 1, 2021, and are of actions taken or likely to be taken by the U.S. Federal Reserve, the Bank of England, the European Central Bank, and the People's Bank of China. Under a "fighting retreat" mode, China's government would accept that growth will need to slow down, but at a gradual pace. If the deceleration is gradual, the government will not intervene and instead will focus on reforms and financial stability. But if the pace is rapid and creates market panic, the government will fight against the trend to stabilize the growth. This will allow the government to engineer a smooth deleveraging process and soft landing.

**Source:** Vanguard, as of November 1, 2021.



## THE BOND MARKET: Rising rates won't upend markets

Despite modest increases during 2021, government bond yields remain below preCOVID levels. The prospect of rising inflation and policy normalisation means that the short-term policy rates targeted by the Fed, the Reserve Bank of Australia, and other developed-market policymakers are likely to rise over the coming year. Credit spreads remain generally very tight. Rising rates are unlikely to produce negative total returns over the medium and long term, given Vanguard's inflation outlook and given the secular forces that should keep long-term rates low.

## GLOBAL EQUITIES: A decade unlike the last

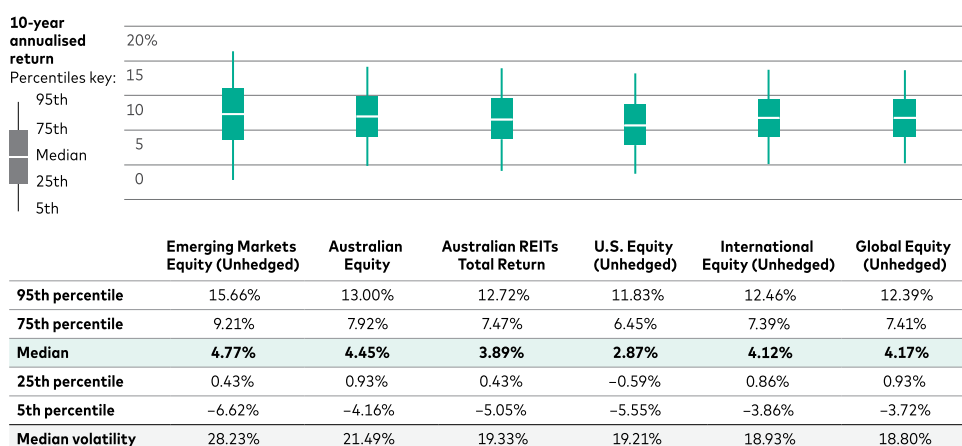
A backdrop of low bond yields, reduced policy support, and stretched valuations offers a challenging environment despite solid fundamentals.

The Vanguard Capital Markets Model fair-value stock projections, which explicitly incorporate such varied effects, continue to reveal a global equity market that is drifting close to overvalued territory, primarily because of U.S. stock prices. Vanguard's outlook calls not for a lost decade for U.S. stocks, as some fear, but for a lower-return one.

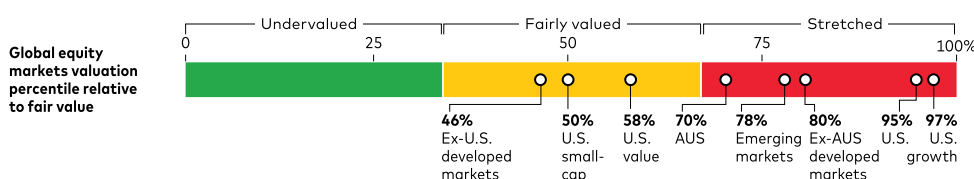
Specifically, Vanguard are projecting the lowest 10-year annualised returns for global equities since the early 2000s. Vanguard expect the lowest ones in the U.S. (1.9%–3.9% per year), with more attractive expected returns for non-U.S. developed markets (5.0%–7.0%) and, to a lesser degree, emerging markets (3.8%–5.8%).

**Figure 8.** Low expected returns for global equities, but opportunities exist

### Equity market 10-year outlook: Setting reasonable expectations



### Valuations drifting higher



**Notes:** Developed market equity valuation measures are the current CAPE percentile relative to the fair-value CAPE for the local MSCI index. The aggregate developed markets valuation measure is the weighted average of each region's (U.S., Australia, U.K., euro area, Japan, and Canada) valuation percentile. The emerging markets relative valuation is based on a relative percentile rank to fair value. Estimated over the period beginning from January 1940 for the U.S., January 1970 for Australia and the U.K., January 1980 for other developed markets, and September 1998 for EM, ending 30 September 2021.

**Sources:** Vanguard calculations, based on Robert Shiller's website, at [aida.wss.yale.edu/~shiller/data.htm](http://aida.wss.yale.edu/~shiller/data.htm), U.S. Bureau of Labor Statistics, Federal Reserve Board, Refinitiv, 30 September 2021 VCM Simulation.

**IMPORTANT:** The projections and other information generated by the Vanguard Capital Markets Model regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results.



Meanwhile, returns for the Australian market are expected to be in the range of 3.5%–5.5%, which is around 2 percentage points lower than Vanguard's outlook last year given elevated valuations.

The outlook for the global equity risk premium is still positive but lower than Vanguard expected last year, with total returns expected in the range of 2 to 4 percentage points over bond returns.

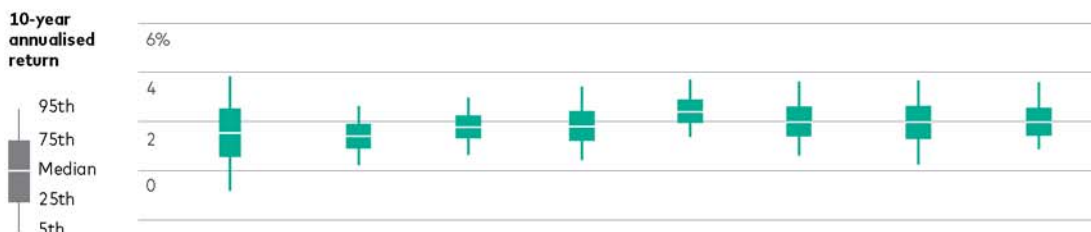
For Australian investors, this modest return outlook belies opportunities for those investing globally, and continues to present a case for being broadly diversified.

Although emerging-market and U.S. equities are above Vanguard's estimate of fair value, they still see these markets as potential sources of diversification for Australian investors given divergences in economic momentum.

Within U.S. markets, Vanguard think value stocks are still more attractive than growth stocks, despite value's outperformance over the last 12 months.

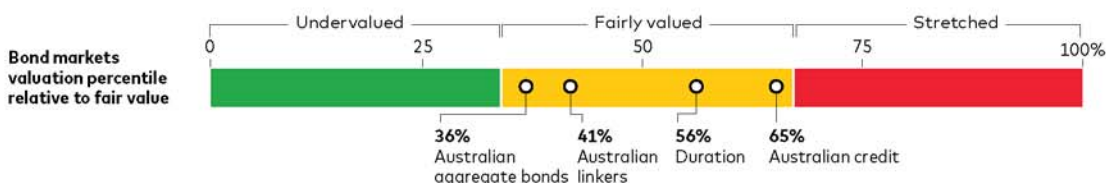
**Figure 9.** Valuation expansion has chipped away at investors' sources of extra yield

**Higher rates have pushed expected fixed income returns higher**



	Australian Linkers	Australian Govt. Bonds	Aggregate Bonds	Global Treasury (Hedged)	Australian Credit	Aggregate Bonds (Hedged)	Australian Inflation	Australian Cash
<b>95th percentile</b>	3.72%	2.45%	2.65%	3.26%	3.57%	3.48%	3.56%	3.46%
<b>75th percentile</b>	2.33%	1.65%	1.87%	2.23%	2.72%	2.43%	2.46%	2.38%
<b>Median</b>	<b>1.30%</b>	<b>1.14%</b>	<b>1.37%</b>	<b>1.56%</b>	<b>2.19%</b>	<b>1.78%</b>	<b>1.74%</b>	<b>1.75%</b>
<b>25th percentile</b>	0.27%	0.65%	0.89%	0.96%	1.72%	1.16%	1.03%	1.20%
<b>5th percentile</b>	-1.20%	-0.09%	0.21%	0.13%	1.11%	0.32%	-0.08%	0.59%
<b>Median volatility</b>	7.0%	5.28%	4.96%	4.22%	4.20%	3.96%	2.24%	1.56%

**Aggregate fixed income appears to be fairly valued, but pockets are stretched**



**Notes:** Valuation percentiles are relative to year-30 projections from the Vanguard Capital Markets Model® (VCMM). Credit valuations are based on current spreads relative to year 30. Aggregate bonds are the weighted average between intermediate-term credit and treasury valuation percentiles. TIPS valuation is the 10-year-ahead annualised inflation expectation relative to years 21-30.

**Source:** Vanguard calculations, using 30 September 2021 VCMM simulation.

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